2023: A YEAR OF TRANSITION WITH MANY SURPRISES

Almost one year ago, we labeled 2023 as 'a year of transition to what?' based on the view that inflation would decline, that official interest rates would reach their peak and a concern that the disinflation process could be bumpy. 2023 has brought us many surprises: the resilience of the labour market in the US and the Eurozone, the extent of monetary tightening, the risk appetite of investors. The biggest surprise was the growth performance of the US economy. Towards the end of the year, the changing message from the Federal Reserve -and to a lesser degree of certain ECB governing council members- with respect to the monetary policy outlook has brought us a another favourable surprise and a hopeful note for 2024.

As the year draws to a close, the time has come to look back and ahead. We will do the latter in our first issue of 2024 and focus in this editorial on 2023. Almost one year ago, we labeled 2023 as 'a year of transition to what?'. The word transition referred to our belief that inflation would decline and that official interest rates would reach their peak. Subdued growth -we expected that the US and the Eurozone would spend part of the year in recession-, would pave the way for more disinflation, gradual rate cuts and a soft recovery in 2024. The reference to 'transition to what?' expressed the view that the journey could be bumpy due to a new, significant and lasting increase in the price of gas, a slower than expected decline in inflation or an impact of past rate hikes that would be bigger than anticipated.

Comparing forecasts with reality can be a sobering exercise and for some variables this was clearly the case in 2023, as illustrated in table 1. The column 'December 2022' refers to projections for 2023 published in December 2022. The column 'December 2023' refers to the estimates for 2023 published this month. For growth and inflation, the data show annual averages except for the Federal Reserve's Summary of Economic Projections, which show percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Interest rate forecasts are for the end of the calendar year.

As expected, Eurozone growth has been subdued but our forecast was clearly too negative whereas the headline inflation forecast was in line with our most recent estimate[1]. Despite its decline, inflation remained well above target forcing the ECB to tighten more than we expected. Market pricing at the end of 2022 also underestimated the ECB actions (chart 1). The ECB staff projections showed a negligible forecast error for GDP growth but a large overestimation for inflation (6.3% versus 5.4%). In the US, inflation came in slightly below our forecasts and those of the FOMC members[2]. The Federal Reserve tightened more than anticipated by the FOMC members, the market (chart 2) and ourselves. The largest forecast error was for US GDP growth: the FOMC members' median projection one year ago was 0.5% and they now expect 2.6%. Our forecast was -0.1% and we now estimate 2.4%. It is testimony to the impressive resilience that the US economy has manifested in an environment of rising interest rates and tighter bank lending conditions. There are numerous potential explanations for this huge positive growth surprise.

EURO SHORT-TERM RATE

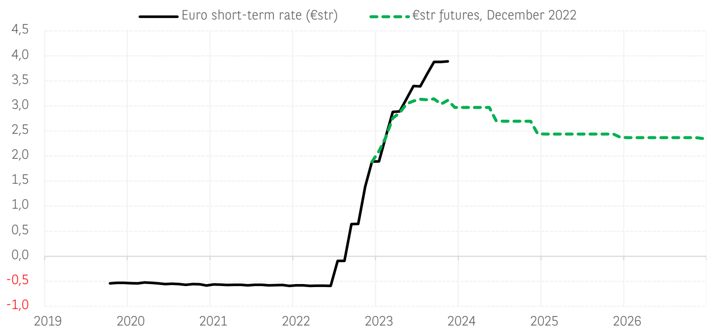

CHART 1

SOURCE: BLOOMBERG, ECB, BNP PARIBAS

FED FUNDS RATE VS FED FUNDS FUTURES

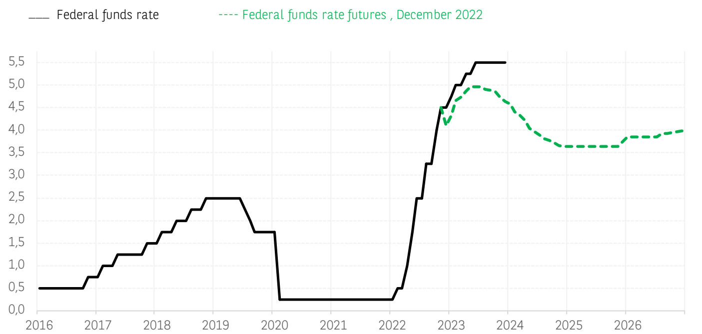

CHART 2

SOURCE: REFINITIV, FEDERAL RESERVE, BNP PARIBAS

1 Inflation data are available up until the month of November so our estimate for the year should be close to the final number once the December data have been released.
2 For the FOMC members, the projection for the deflator of core personal consumption expenditures (core PCE) is shown because this is the Federal Reserve's preferred inflation metric.

> The changing message from the Federal Reserve -and to a lesser degree of certain ECB governing council members- with respect to the monetary policy outlook means that 2023 ended with a favourable surprise and a hopeful note for 2024.

Fixed rate mortgages shield households from rising interest charges on their outstanding stock of mortgage debt. Most nonfinancial corporate debt is in the form of fixed rate corporate bonds issued before 2022, so the average interest rate on the outstanding debt is still low[3]. Both factors slow down the transmission of higher policy rates to the real economy. The strength of the labour market also plays a role. Although the pace of job openings has slowed, it remains well above the long-term average. The unemployment rate is still very low and labour hoarding by companies has limited the increase in the lay-off rate when growth slowed down after the initial post-Covid-19 recovery[4]. Another factor are the excess savings accumulated during the Covid-19 pandemic, which have boosted spending this year by enabling households to save less and spend more.

Another surprise was the 'risk on' mindset of investors: despite rising official interest rates, major equity indices delivered a strong performance and corporate bond spreads remained tight. Investors were probably comforted by the resilience of economic growth in the US and of the labour market in the US and the Eurozone. As the policy rate converged to its terminal value, markets increasingly started to look beyond the peak, pricing in rate cuts as of the spring of 2024. The changing tone from the Federal Reserve and to a lesser degree of certain ECB governing council members gave further impetus to this development. 2023 thus ended with a favourable surprise and a hopeful note for 2024[5].

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3 This point was in U.S. Economic Outlook and Monetary Policy Transmission, Remarks by Philip N. Jefferson, Vice Chair, Board of Governors of the Federal Reserve System, at "Beyond the Business Cycle: Adapting to a New Global Paradigm", 65th Annual Meeting of the National Association for Business Economics, Dallas, Texas 9 October 2023.
4"*Labour hoarding corresponds to a reluctance of firms "to let go of workers in the face of weaker growth, fearing difficulties if they need to rehire."* Source: From hiring difficulties to labour hoarding?, Federal Reserve Bank of San Francisco Economic Letter, 18 December 2023.
5 The topics of this editorial have also been discussed in our recent video: 2023 a surprising year until the end, EcoTV Week, BNP Paribas, 15 December 2023.

FORECASTS AND ESTIMATES FOR 2023

	BNP Paribas		ECB Staff Projections		Federal Reserve Summary of Economic Projections	
	December 2022	December 2023	December 2022	December 2023	December 2022	December 2023
Eurozone						
Real GDP growth (%)	-0,5	0,5	0,5	0,6		
Headline inflation (%)	5,6	5,5	6,3	5,4		
ECB deposit rate (year end)	3,0	4,0				
US						
Real GDP growth (%)	-0,1	2,4			0,5	2,6
Headline inflation (%)	4,4	4,1				
Core PCE					3,5	3,2
Federal funds rate (year end)	5,25 (upper end of target range)	5,5 (upper end of target range)			5,1 (midpoint of target range)	5,4 (midpoint of target range)

SOURCE: BNP PARIBAS, ECB, FEDERAL RESERVE